and it has primarily benefited small and medium-sized companies. For example, of the projects approved by the New York City Industrial Development Agency between January and November 1979, more than three-fourths were for companies with net annual sales of less than $20 million, and more than half of these projects were for firms with net annual sales of between $1 and $5 million.[4] Similarly, more than three-fourths of the IRB-financed manufacturing facilities approved by the Massachusetts Industrial Finance Agency (MIFA) in 1978 and 1979 were undertaken by companies with annual sales of less than $20 million. These smaller firms had an average net worth of $1 million, average annual sales of $4.7 million and an average of 87 employees. The average issue size for these firms was $1.1 million.[5] These figures seem to reflect national practices.

To determine national patterns of small issue use, CBO examined a random sample of nearly 800 IRBs issued in 1978 and 1979.[6] The results indicated that IRB users tend to be closely held firms; less than 10 percent of the firms using small issues were listed on any of the national or regional stock exchanges.

More than three-fifths (61 percent) of the total number of issues in the sample were for less than $1 million, while only 12 percent of the issues were for more than $2.5 million. In terms of dollar volume, issues of less than $1 million accounted for 24 percent of all sales, while issues of more than $2.5 million

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4. Memorandum from the New York City Industrial Development Agency (December 27, 1979).

5. Letter from Robert Patterson, Executive Director, Massachusetts Industrial Finance Agency (November 27, 1979).

6. The sample consisted of 778 firms, which represented approximately 10 percent of the issues in each of 35 states that provided listings of the companies using IRB financing in 1978 and 1979. The states represented in the sample were Alabama, Arkansas, Connecticut, Delaware, Florida, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Missouri, Montana, Nebraska, New Jersey, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Utah, Vermont, Virginia, and Wisconsin.

accounted for 44 percent. Similar findings emerged from examining a sample of firms using small issues in 1980.[7]

Issue Size (in Millions of Dollars)	Percent of Projects 1978/79	Percent of Projects 1980	Percent of Dollar Volume 1978/79	Percent of Dollar Volume 1980
Less than 1.0	61	64	24	20
1.0	10	5	9	4
1.01 - 2.49	17	19	23	24
2.5 - 5.0	9	7	26	19
More than 5.0	3	6	18	34

In 1979, although the capital expenditure limit was raised from $5 million to $10 million, only 6 percent of the 1979 issues was for more than $5 million. In terms of dollar volume, however, these bonds accounted for 23 percent of small issue sales. In 1980, bonds exceeding $5 million again accounted for only 6 percent of all issues, but they represented 34 percent of all sales. Nationwide, the average issue size was $1.1 million in 1978, $1.4 million in 1979 and $1.3 million in 1980. (The reduction in the average size of bond issues in 1980 might reflect the smaller number of states represented in the sample.)

Large Corporations and the Small Issues Market

Although no hard and fast rules apply, the IRBs floated to assist large corporations tend to involve brokerage houses or investment banks, which may either negotiate a private placement or

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7. CBO's 1980 sample was based on a random selection of issues from lists and reports submitted by 23 states. As of March 1981, similar data on 1980 sales were unavailable from the remaining states. The sample consisted of 425 firms, representing 10 percent of the issues in each of the following states: Arkansas, Connecticut, Delaware, Iowa, Illinois, Indiana, Kentucky, Maine, Massachusetts, Michigan, Minnesota, Nebraska, New Hampshire, New Jersey, North Carolina, North Dakota, Pennsylvania, Rhode Island, South Carolina, Texas, Utah, and Vermont.

offer the bonds for public sale. Occasionally, commercial banks privately place bonds for corporate customers. In effect, these issues are tax-exempt corporate bonds, and, if publicly sold, their ratings are generally the same as the senior secured debt of the corporation. Their benefits to the corporations derive primarily from the lower interest rates that IRBs offer.

In terms of both the number and volume of issues, these bonds constitute a small proportion of small issue sales. Of some 8,000 small issues in 1978 and 1979, only 7 percent went to the top "Fortune 50" nonindustrial companies or the top Fortune 1,000 industrial firms. (The smallest firm on the Fortune 1,000 list had sales in 1978 of more than $110 million.) CBO found that, in terms of the dollar volume of sales in 1978 and 1979, only 16 percent was for Fortune 1,000 or Fortune 50 companies.[8]

The $10 million capital expenditure limit effectively keeps most large corporations from making much use of small issues; however, the limit applies only to the cost of facilities within an incorporated county or municipality. Corporations that have operations consisting of a large number of relatively low-cost and geographically dispersed facilities can use small issues to good advantage.

Manufacturing firms with many small plants and national retail and fast food chains have used small issues to finance major expansion programs. For example, according to Moody's Bond Record, K-Mart, the second largest retailer in the country, financed 35 stores with IRBs in 1980 alone; between 1975 and 1980, K-Mart (known as S.S. Kresge until mid-1977) used $220.5 million of IRBs to open some 96 stores in 19 states. Similarly, McDonalds financed the opening of 32 new restaurants in Pennsylvania and Ohio alone in 1979.[9] Eckerd Drugstores, Federated Department Stores, and Kroger are among the other retailing giants that have used IRBs. Among manufacturers of foodstuffs, household products, and textiles,

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8. Refers to corporation listings compiled annually by Fortune magazine.

9. Moody's Bond Record, January 1981, pp. 109-122. These data may well be an underestimate, since they exclude privately placed, unrated issues.

leading IRB users have been Beatrice Foods, Burlington Industries, General Mills, Nabisco, Pepsico, and Proctor and Gamble.[10]

A common practice, particularly among major chemical, paper and pulp corporations, is the use of $1 million small issues together with other and usually much larger pollution control bonds. The capital expenditure requirements for the facilities of these corporations are too large to permit them to use more than $1 million of small issue IRB financing. With relatively little additional paperwork, however, they can simultaneously float pollution control bonds and small issue IRBs to obtain lower-cost financing for up to $1 million of equipment purchases. Roughly one-half of all of the IRBs issued for companies rated by Fortune are for exactly $1 million. (These bonds constitute 4 percent of all issues and 3.4 percent of total sales volume.) A number of major firms make frequent use of the $1 million issue, including Allied Chemical, Container Corporation of America, Crown Zellerbach, International Paper, Hammermill Paper, Kimberly Clark, Stauffer Chemical, and Weyerhauser, to name a few.[11]

The Direct Placement Market for Medium-Sized and Smaller Firms

For smaller firms, IRBs are essentially a means of obtaining tax-exempt loans. The beneficiaries of most small issues are privately held firms with annual sales or total assets below those of the companies appearing on any of the Fortune listings. These middle-market and smaller firms are generally creditworthy enough to secure conventional financing without government guarantees. Their long-term debt capital, however, comes primarily from commercial banks, rather than from the stock or bond markets.[12]

Typically, a firm will approach its local bank for a loan to cover the costs of plant acquisition, construction, or equipment. Instead of a conventional mortgage or a loan, the firm may request that the local industrial development authority (IDA) issue IRBs

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10. Moody's Bond Record.

11. Moody's Bond Record.

12. The beneficiaries of small issues are generally no less creditworthy than recipients of conventional loans, and their default rates are no higher.

for the desired amount. The bank and the firm work out the terms of the bond issue--the amount, the maturity, and the interest rate. The bank agrees to purchase the entire issue for its own loan (and occasionally, investment) portfolio, and the government issuing authority (usually the most passive of the partners in these arrangements) serves as a conduit of the tax-exempt status of the bonds. These direct placements require bond counsel opinions to assure that the bonds are tax-exempt, but they rarely involve underwriters; thus, the fees are relatively low. On the other hand, the bond issues for small firms are unrated, and interest rates are higher than they would be on rated issues of large firms.[13]

From the standpoint of both the banks and their customers, these transactions are much like conventional loans, but they have some advantages. The lender gets a higher interest rate than on other tax-exempt bonds, primarily to compensate for higher risks. The borrower profits from a lower interest rate and is occasionally able to negotiate financing for a longer term or for a larger amount. Some state laws prohibit banks from making commercial mortgage loans for more than a fixed percentage of the appraised value of the property. In these cases, substituting small issues for conventional mortgages may provide a means of obtaining full (that is, 100 percent) financing. In general, however, the amount of the loan depends on the credit of the firm, rather than on the value of the property being financed.

During 1979, small issue IRBs were usually floated at a fixed interest rate that ranged between 6.5 percent and 10 percent, depending on the type of project and the creditworthiness of the borrower. By year's end, the interest rates on most unrated small issues were between 8.75 and 9.5 percent. As interest rates soared, however, the trend for both conventional and small issue financing shifted from fixed to floating rates, and loan terms became shorter. Depending on the borrower, interest rates floated

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13. The publicly sold bonds of major corporations, state and local governments are generally rated for creditworthiness by nationally recognized rating agencies, such as Moody's or Standard & Poor's. Privately placed bonds are generally unrated. Banks and other institutional lenders evaluate the creditworthiness of small and medium-sized firms and set interest rates accordingly.

anywhere between 55 and 75 percent of the prime lending rate. For both borrowers and lenders, these developments have reduced the degree of certainty usually associated with long-term debt financing. At present, a 10-year term is common for most small issues; in 1978, terms ranged up to 25 years. Some banks are now buying small issue IRBs to provide firms with "bridge financing"--short-term loans, usually for three years or less, that subsequently will be refinanced.

A few states have set up programs that are specifically geared toward simplifying tax-exempt financing procedures for small firms. The largest of these is Pennsylvania's industrial revenue mortgage program.[14] Tax-exempt mortgages adhere to the requirements for small issue IRBs, and they are tax-exempt under the same section of the Tax Code. In fact, they are tax-exempt bonds by another name. The advantage of using revenue mortgages is that they circumvent the need both for underwriters and for private, nationally recognized bond counsel; they thereby avoid some of the administrative expenses of issuing bonds. The legal opinions necessary to assure the tax-exempt status of revenue mortgages generally come from attorneys on the staffs of local Pennsylvania IDAs. Although local agencies usually charge for these services, the net effect of revenue mortgages is to provide a relatively inexpensive and simple means for making small loans to locally based companies.

A few other states, notably Arkansas, Iowa, and Maryland, have similar programs. The states describe their small issue programs as tax-exempt loan or mortgage programs, which, according to the Maryland Industrial Development Financing Authority (MIDFA), enables "borrowers to obtain loans at a higher percentage of

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14. In a typical arrangement, a company will assign the land for $1 and the promise of project financing to a local IDA. The IDA, instead of floating a bond issue, gets a mortgage loan from a local bank. In turn, the IDA leases the property and equipment to the company, which makes rental payments equal to the amount necessary to cover the principal and interest on the mortgage. Alternatively, a company could buy the property under an installment sales agreement, with payments equal to the principal plus interest on the loan. Title passes to the company. The security for the loan is a first mortgage on the land and building, which is assigned to the bank.

project cost, at a lower interest rate, and for a longer term than is normally available from conventional sources."[15] The MIDFA approves firms for tax-exempt financing and often insures a portion of the so-called "loan." These transactions go forward without the advice of private bond counsel; instead, a representative of the state Attorney General's office advises on the tax-exempt status of the "loans." Although the MIDFA program is designed for companies of all sizes, it appeals primarily to smaller firms. About half of MIDFA's clients had a net worth of less than $1 million at the time of project approval.

REGIONAL PATTERNS OF SMALL ISSUE IRB USE

Although industrial development bonds originated in the South, the Northeast and North Central regions now use them more heavily.[16] Of a total of $7.1 billion of small issues authorized in 1979, the Northeast accounted for $2.8 billion, or 39.5 percent; the North Central region for $2.1 billion, or 29.2 percent; the South for $2.0 billion, or 27.8 percent; and the West for less than $0.3 billion, or 3.7 percent. The three states that still refrain from using IRBs are all western.

In 1979, the four largest issuers accounted for roughly 45 percent of the small issue financing in the country. These were Pennsylvania--by far the leading issuer--Minnesota, New Jersey, and Ohio. Pennsylvania alone accounted for nearly one-fourth of all small issue IRB financing. All four of these states have statutes permitting IRB financing for a wide variety of projects; however, New Jersey requires targeting at the state level. In these four

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15. Brochure of the Maryland Industrial Development Financing Authority (Baltimore, Maryland), p. 1.

16. The data in this section are based on statutes, reports and lists of issues that state and local agencies submitted to CBO. For details, see Appendixes A and B.

    The Census Bureau divides the country into four regions, which include the following states:

    Northeast -- Maine, Vermont, New Hampshire, Massachusetts, Rhode Island, Connecticut, New York, New Jersey, Pennsylvania. These states may be further subdivided into two areas: Middle Atlantic --

states combined, 32 percent of the projects authorized for small issue IRB financing in 1979 were for manufacturing, 14 percent for warehouses and other distribution facilities, and 54 percent for commercial projects.

The use of small issues is most widespread and least restricted in the Middle Atlantic and North Central states (which account for roughly three-fifths of all sales). In general, southern states have been the most reluctant to depart from traditional practices of using small issues primarily for investment in manufacturing, but patterns are now changing rapidly. As of the end of 1979, only six southern states had laws imposing few or no restrictions on IRB use. Within a year, another five--Delaware, Florida, Kentucky, Louisiana, and South Carolina--had passed legislation permitting tax-exempt financing for a wide variety of commercial projects. In Alabama, the use of small issue IRBs had for years been largely confined to manufacturing and medical facilities. During 1980, the Alabama State Securities Commission, which approves IRB issues, began receiving large numbers of applications for retail ventures and held hearings to clarify the intent of the state's legislation.[17] Litigation on the issue is now pending. In New England, use of tax-exempt bonds for retail ventures remains

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New York, New Jersey and Pennsylvania -- and New England -- Maine, Vermont, New Hampshire, Massachusetts, Rhode Island and Connecticut.

South -- Maryland, Delaware, District of Columbia, West Virginia, Virginia, North Carolina, South Carolina, Georgia, Florida, Kentucky, Tennessee, Alabama, Mississippi, Texas, Oklahoma, Arkansas and Louisiana.

North Central -- North Dakota, South Dakota, Nebraska, Kansas, Minnesota, Iowa, Missouri, Wisconsin, Michigan, Illinois, Indiana, Ohio.

West -- Washington, Oregon, California, Montana, Idaho, Wyoming, Utah, Colorado, Arizona, New Mexico, Hawaii, Alaska, Nevada.

17. Alabama Securities Commission, Public Hearings on the Matter of Expanded Use of Tax Free Industrial Development Bonds, Montgomery (September 3 and 4, 1980).

relatively uncommon. Among the western states New Mexico, Nevada, California, and Alaska impose restrictions on IRB use: New Mexico prohibits IRB financing for retail stores. California and Nevada restrict use of the bonds to industrial and related facilities. Alaska restricts use of the bonds for nonindustrial purposes primarily to tourism, mining and commercial fishing enterprises (see Appendix C for more details on specific state practices).

IRBs AND LOCAL PLANNING PROCESSES

Under current federal law, states and localities have a great deal of latitude concerning their use of IRBs. They may or may not choose to combine the bonds with other efforts to promote economic development. IRBs may be entirely under the control of the state, or the state may relinquish all authority to local government. The process for issuing bonds may include public participation, or it may be a routine administrative action that takes place without public knowledge.

Although few localities may issue IRBs without enabling state legislation, practices vary widely with local custom and the use of the proceeds. Some localities exercise strong control over all development decisions, including how IRBs are used. Elsewhere, the only decision a local development authority makes is whether or not to issue bonds at all.

The authority to issue IRBs rests with various state and local agencies. In New Jersey, for example, the State Economic Development Authority is the only agency empowered to issue IRBs. In Massachusetts, both local authorities and the Massachusetts Industrial Finance Agency issue bonds. In Georgia, local agencies--cities, counties, incorporated towns, and local development authorities--may issue IRBs, while state agencies have no role in the process. In Kansas, only counties and cities may issue IRBs. In Wisconsin the authority is limited to cities. And in New York, it is restricted to local authorities. (Appendix D indicates the multiplicity of issuing authorities on a state-by-state basis.)

Local industrial development authorities, which are not-for-profit public corporations, issue IRBs in some 23 states.[18]

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18. These are also known as industrial development boards or economic development commissions.

Although these authorities are created by state and local governments, many have a degree of autonomy that offers significant advantages. First, even though special revenue bonds, by definition, are not general obligation bonds, the authority is a useful way for a local government to detach itself and its credit from a bond issue. Second, many state constitutions prohibit donating or lending public funds to private entities. In most of the states where such constitutional provisions prevent the state or its cities or counties from issuing IRBs, the courts have permitted local authorities to perform the same function. Finally, some states and localities require that their bond issues be considered at public hearings or submitted to public referenda. The use of authorities is usually sufficient to circumvent these requirements. In general, the local government appoints the members of the authority, who may come from the private sector, from public agencies, or both. Nongovernment members usually include representatives from industry (including banks, insurance companies, and real estate) and, occasionally, labor.

In most cases, localities determine the kind of development that will take place with tax-exempt financing. The local issuing authority may or may not be acting in accordance with a plan for development of the area. Similarly, the amount of public participation in decisions concerning bond issues varies greatly from one locale to another. Some localities require public hearings; most do not.

With the growing use of IRBs for retail businesses, public participation has become an issue. Established merchants and restaurateurs, who have never benefited from tax-exempt financing, have begun to complain about the use of subsidies to set up competitive establishments and about the failure of local authorities to notify the public of proposed bond issuances. In July 1980, more than 2,200 voters in Ravalli County, Montana, signed petitions calling for a referendum on the use of $4 million in IRBs to construct a shopping center, with K-Mart as a principal tenant. Local merchants called the county's approval of the bonds unfair, succeeded in having the issue put on the November general election ballot, and won. Similar problems have arisen in places as far apart as Wetumpka, Alabama, and The Dalles, Oregon. A few localities have refrained from taking advantage of legislation expanding the uses of IRBs, because the availability of tax-exempt financing to enterprises that will compete with conventionally financed ones seems to be particularly troublesome to retail firms.

In some cases, state agencies must approve the proposed issues of cities, counties, or local development authorities. In others, no approval is required. The approval is usually more formal than substantive. In some states, for example, the approval of the state agency responsible for commerce, economic development, or industrial finance may imply review and approval of a project based on its potential effect on the local economy. In most cases, however, approval means compliance with state law, rather than analysis of the economic effects of the project. In some instances, especially (but not only) when the reviewing agency is the state treasury or securities commission, project approval focuses on whether the borrowing firm is financially sound, and on whether the bond issue complies with federal and state tax and securities laws. In such instances, the aim is to guard against fraud.

Some states have no review procedures but require that a designated agency be informed of IRB transactions. Other states impose no requirements on local issuing authorities and make no attempt to keep track of IRB sales. These include Georgia, Missouri, Nevada, and West Virginia.

In many states, the use of small issue IRBs has no relationship to local planning processes. In three states--Illinois, Pennsylvania, and Virginia--local authorities can issue bonds for projects in other communities. A few years ago, in a much publicized case, a local industrial development authority in outlying Chester County, Pennsylvania, issued a $400,000 tax-free IRB to purchase a seven-story building that housed an "adult" bookstore and a topless go-go bar in downtown Philadelphia.[19] The Philadelphia Industrial Development Commission had refused to issue the bonds. In this instance, the Pennsylvania Commerce Department approved the transaction on grounds that it conformed to state law, and the local IDA collected a fee for its services.

In the summer of 1980, the village of South Barrington, Illinois, appealed to the courts for a ruling on its authority to issue $18 million in IRBs to finance the opening of two Marshall Field department stores in nearby communities. The village also had an agreement on the back burner to issue $9.3 million in IRBs for another department store--Carson, Pirie, Scott--in Carpenters-

19. Dun's Review (September 1980); Philadelphia Inquirer (December 9, 1976).

84-774 O - 81 - 4

ville. For its services, the village would collect fees of $100,000 from Marshall Field and $67,000 from Carson, Pirie, Scott.[20]

Geographic Targeting. A few states target small issues toward designated areas. These efforts generally apply only to commercial projects. Massachusetts, for example, permits the location of IRB-financed industrial projects anywhere in the state, but other projects--retail stores and office buildings, for example--are eligible for tax-exempt financing only if they are located in "commercial area revitalization districts."[21] These districts are designated in local revitalization plans and approved by the State Secretary of Communities and Development. Iowa also limits commercial use to urban redevelopment areas. New Jersey restricts IRB-financed commercial projects to areas that include roughly one-third of the state's population. In order to qualify, a New Jersey area must either meet the eligibility requirements for federal UDAG funding or satisfy other measures of "distress" that take into account unemployment, per capita income, real property tax assessments, and income-assistance expenditures. Rhode Island prohibits the use of IRBs for retail establishments but permits it for office buildings that contribute to downtown redevelopment in older cities. Texas has a broad statute, but in practice, the state's Industrial Commission has limited nearly all of its approvals to industrial projects.

In the absence of federal guidelines, targeting is best accomplished when it is articulated as state policy. Without such state requirements, a locality that chooses to direct investment to distressed areas is likely to face competition from other cities or towns that have no such restrictions. Consequently, the likelihood that IRB-financed development will be channeled to areas with greater needs is slight, unless the state imposes such requirements. Some localities require targeting nevertheless. In New York City and in Erie County (which includes the city of Buffalo), criteria for the use of IRBs for commercial projects are extremely stringent, despite a broad New York State statute. These criteria

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20. Chicago Tribune (May 11, 1980); Barrington Courier-Review (August 21, and September 11, 1980).

21. Massachusetts Industrial Finance Agency, Annual Report (1979 and 1980).

not only restrict IRB-financed commercial and recreational projects to specifically designated redevelopment areas; they also require evidence that the project could not go forward without IRBs, and that it will provide "substantial employment and capital investment."[22] New York City has similar guidelines. For a commercial project to be considered, the applicant firm must demonstrate community support, prepare a market study, and submit a cost analysis comparing tax-exempt with conventional project financing. Retail ventures qualify for small issue financing only if they are constructed on city-owned property or if they are associated with a UDAG project. These constraints assure that the city's Board of Estimate will review the project. As of January 1981, not one of the 139 projects funded in New York City was for a commercial purpose.[23]

The targeting of IRBs to areas in need of redevelopment encourages their use in conjunction with federal or other renewal efforts. In Massachusetts, a state mortgage insurance program for building rehabilitation in designated "revitalization districts," and tax credits and deductions to promote employment in central business districts, also complement the use of IRBs. In New Jersey, the state Economic Development Authority may guarantee up to 30 percent of a bond issue. It also may guarantee bank loans and make direct loans. Roughly two-thirds of the authority's loan guarantees and direct loans are for projects in distressed urban areas.

<u>Helping Riskier Businesses</u>. While some 7 states impose geographical restrictions on small issues, a few others have instituted programs that make the bonds available to smaller and riskier enterprises. These include guarantees and the use of general obligation bonds. Some states use a combination of these programs. For example, to reduce costs and help small firms, the Maine Guaranty Authority will package a bond issue for several companies at once and use the proceeds to make low-interest loans that conform to the requirements for small issues. The Maine authority can also guarantee as much as 20 percent of each loan.

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22. Erie County IDA memorandum, "Policy and Procedures for Commercial and Recreational Project Revenue Bonds" (March 3, 1980).

23. New York City IDA, "Commercial Project Policy" statement. Letter from New York City IDA (March 6, 1981).

The Connecticut Development Authority (CDA) has an umbrella revenue bond program tailored to small industrial or research and development companies with sales and assets below $5 million. (In fact, most of the companies served have sales and assets below $1 million.) Generally, banks and insurance companies refer the firms to the CDA, which will float a single bond to finance loans to several companies for a maximum term of 25 years. The CDA will also provide mortgage insurance for up to the maximum loan amount of $850,000. The New York State Job Development Authority floats general obligation bonds to finance small issue loans for industrial plants and research and development facilities. These loans can cover up to 40 percent of project costs. Alaska instituted an umbrella bond program in mid-1980; Delaware and Louisiana use general obligation bonds for companies that are unable to get financing with revenue bonds.[24]

IRBs and State and Local Tax Incentives. In many states, IRBs are part of a package of tax benefits that have developed over the years to attract new industry and encourage expansion of existing businesses. These include exemptions from state and local income taxes, sales taxes, and property taxes. Again, practices vary widely. In Wisconsin, for example, IRBs are exempt from federal taxes only.[25] In Alabama and New York, on the other hand, they are not only exempt from state and local income taxes, but the projects they finance are eligible for local property tax exemptions or abatements and for exemptions from state and local sales taxes on

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24. A proposed Internal Revenue Service regulation, with an effective date of on August 24, 1981, would make the continuation of umbrella bond programs, as currently structured, impossible. The proposed regulation holds that multiple lots of bonds of $1,000,000 each, or less, will be treated as a single large issue not qualifying for tax exemption under Section 103(b)(6)(A) if (1) the obligations are sold at substantially the same time, under a common marketing plan, and at substantially the same rate of interest, and (2) a common or pooled security will either be used or available to pay debt service on the obligations. The regulation would apply only to projects initiated after August 24, 1981.

25. In Minnesota, IRBs held by banks and other corporations are subject to state income tax; bonds held by individuals are exempt.

materials and equipment. At times, these benefits are so attractive that if a project exceeds the capital expenditure limits for small issues, it may be financed with taxable IRBs. (Typically, a $25 million project would be financed with $1 million of tax-exempt small issues and $24 million of taxable IRBs.)

Under most lease arrangements, IRB-financed facilities are the property of the issuing authorities. Since these are public entities, they pay no property or sales taxes. Many states, however, require that the corporations leasing IRB-financed facilities make payments in lieu of taxes.

IRBS AND FEDERAL PROGRAMS

In addition to UDAG, several other federal programs can ease access to credit or provide interest subsidies to businesses. These include assistance offered by the Small Business Administration (SBA), the Economic Development Administration (EDA), the Farmers' Home Administration (FmHA, U.S. Department of Agriculture). The UDAG program, however, most clearly complements IRBs, and the few states and cities that actually target IRBs do so partly to encourage IRB use with UDAG funds. UDAG funds are offered in part to leverage private investment in industrial and commercial projects in distressed areas. The aim of UDAG funding is to stimulate economic development and neighborhood reclamation by promoting partnerships between the public and private sectors. HUD officials connected with the UDAG program estimate that, in 1979, roughly 40 percent of UDAG projects were coupled with IRBs. The Congress encouraged the combination of these programs when it raised the capital expenditure limit on IRBs associated with UDAG projects to $20 million.

The other agencies that provide assistance to businesses--EDA, FmHA, and SBA--each operate guarantee and direct loan programs. The EDA Business Development Loan Program provides loans and guarantees to firms to generate and save jobs in distressed areas (according to the EDA definition).[26] Direct loans are for fixed assets up to a maximum of 25 years, and they cannot exceed 65

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26. The UDAG and EDA programs define "distressed" areas quite differently. Approximately one-third of the population lives in cities and towns eligible for UDAG assistance; more than four-fifths of the population lives in areas eligible for the EDA Business Development Loan Program.

84-774 O - 81 - 5

percent of total project costs. Guaranteed loans may cover as much as 90 percent of the full amount and may have terms as long as 25 years at prevailing interest rates.

FmHA has similar programs targeted to rural communities and small towns (less than 50,000 population, with primary emphasis on small towns with populations below 25,000). The programs have no set loan limits, but 97 percent of all loans are below $5 million, and 31 percent are below $1 million. Most of this assistance is in the form of guarantees.

SBA provides loans and guarantees to small businesses.[27] Under Section 7(a) of the Small Business Act, the SBA provides direct loans, or participates with other institutions in providing loans, for periods up to 20 years and amounts not exceeding $150,000. Loan guarantees cover 90 percent of the amount up to a maximum of $300,000. In exceptional cases, these limits can go up to $350,000 and $500,000, respectively. Where small issues provide cost of capital subsidies primarily to creditworthy firms, Section 7(a) loans and guarantees provide last-resort financing.

Under the Sections 501, 502, and 503 programs, the SBA provides direct and guaranteed loans through state and local development corporations. These programs are development tools, and they have broader limits, with terms ranging up to 25 years and loan limits up to $500,000. Most loans are made through the Section 502 Local Development Company Program.

At present, federal guarantees cannot be used to back tax-exempt small issues. Moreover, until the passage of the SBA Section 503 program late in 1980, federal administrative procedures hindered the use of federal guarantees to back conventional loans for projects that also had tax-exempt financing. With the passage of the 503 program, a firm may now use small issues for partial project financing, combined with a second position SBA guaranteed conventional loan at market interest rates. This permits firms that are too risky to qualify for full small issue IRB financing to benefit from loans that are partially tax exempt.

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27. These include manufacturing firms with 250 to 1,000 employees; retail firms with $2 to $7.5 million in annual sales; wholesale firms with $9.5 to $22 million in sales; construction firms with average annual receipts over three years not exceeding $9.5 million; and service firms with receipts of $2 to $8 million, depending on the industry.

CHAPTER IV. THE EFFECTS OF SMALL ISSUE IRBS

Access to tax-exempt financing for industry can affect private investment decisions, tax revenues at all levels of government, municipal borrowing costs, the allocation of capital, and in special circumstances, the amount of commercial credit available. The extent of these effects depends on the overall volume of small issue IRB sales.

FUTURE VOLUME

Future growth of small issue financing will hinge on a number of developments:

- The overall level of business investment in plant and equipment,

- The demand for loans and the supply available from the banking community and the bond market,

- Interest rate levels and the differences between tax-exempt and conventional rates, and

- The profits of banks and casualty insurance companies (the main purchasers of IRBs) and the consequent need of such institutions to offset income tax liabilities with tax-exempt holdings.

Between 1975 and 1979, small issue IRB financing grew at an estimated average annual rate of 56 percent, according to CBO estimates.[1] This rate reflects a doubling of sales between 1978

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1. The actual rate of growth may have been greater or less than CBO data indicate, since private sales not picked up in CBO's survey may have grown at a faster or a slower rate than those that were included. In addition, some of the increase in more recent years may partly reflect improved data gathering and reporting at the state level.

and 1979 alone, which was exceptional. Without the rise in capital expenditure limits for small issues and the wide spread between tax-exempt and conventional interest rates, the growth in small issue sales in 1979 would have been much less dramatic. Between 1975 and 1978, sales had grown at an estimated average annual rate of 39 percent. For 1980, however, indications are that small issue IRB sales grew at a much slower rate.

As of mid-1980, banking and development officials voiced expectations that the growth rate of IRB sales would slacken beginning in the latter half of the year and that the trend would continue into 1981.[2] These expectations derived from observations that business investment in plant and equipment would decline, that loan demand would weaken, that banks and insurance companies would show lower profits, and that with less income to offset tax liabilities, these institutions's need for tax-exempt securities would diminish. At the end of 1980, these predictions seemed to be borne out: Between 1979 and 1980, IRB sales increased by less than 20 percent. Although sales in some states showed much greater increases, sales elsewhere had, at least temporarily, leveled off. As of mid-1981, many banks and insurance firms were showing increasing reluctance to take on new commitments for IRB financing, indicating either that they had begun to experience or were expecting shrinking profits, or that they were offsetting tax liabilities in other ways.

The long-term outlook for small issue IRB sales is less clear than it is for next year. The possibilities range from a modest growth rate (roughly 10 percent a year through 1986) to a much steeper rate after the end of 1981. In view of recent trends, the former assumption is quite conservative. The latter more closely parallels past experience. Nothing in the current economic situation indicates that sales will decline from present levels. A large increase in bond issues for more than $5 million, an increase in the use of small issues in combination with UDAG funding, or cutbacks in other federal programs could further spur growth. Current indications, however, are that without a legislative change permitting higher capital expenditure limits, the likelihood of sales' growing more rapidly than they did between 1975 and 1978 is small.

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2. Comments on future trends in small issue sales are based both on available data and on discussions with IDA and bank officials.

Continued growth of the small issues market depends in large part on the purchasing capacity of banks and other financial institutions. At present, most small issues are relatively illiquid. A secondary small issues market exists primarily for the rated bonds of larger firms. If money center banks and other financial institutions are successful in creating a secondary (or resale) market for unrated small issues, IRB sales could increase by much larger amounts than current evidence indicates.[3] A secondary market might develop if private insurance for small issues were to become available, if large regional and money center banks were to sell small issues backed by letters of credit, or if financial institutions could develop new retailing mechanisms, such as small issue mutual funds. A number of financial institutions and development officials are trying to devise ways to develop a secondary market for small issues.

EFFECTS ON FEDERAL REVENUES

The cost to the federal government of providing tax exemption for small issues in any year depends on the volume of bonds issued, prevailing interest rates, and the marginal tax bracket of investors in tax-exempt securities. As of the end of 1979, the value of outstanding small issue IRBs amounted to $24.7 billion. In fiscal year 1980, federal revenue losses amounted to more than $700 million. Assuming current law remains in effect and growth in sales is modest, the volume of IRBs outstanding would increase from $32.9 billion in calendar year 1980 to $101.5 billion in calendar year 1986, resulting in fiscal year revenue losses that rise from approximately $1 billion in 1981 to $2.9 billion in 1986. The

3. The potential for growth is significant, since the current annual volume of long-term bank loans and bond issues that might qualify for IRB financing under present law is about $50 to $100 billion. Small issues now account for a relatively small share of that market (between 8 and 16 percent). If small issue IRBs captured a sizable share of the market, future IRB volume would substantially exceed CBO's upper bound projections. New techniques for marketing the bonds, coupled with cutbacks in other federal programs, could lead to a boom in new issues. The evidence now available, however, is insufficient to support such a projection, particularly since proposed IRS regulations (see footnote, page 24) could hinder efforts to develop a secondary market for unrated IRBs.

TABLE 2. SMALL ISSUE IRB SALES AND ASSOCIATED FISCAL YEAR REVENUE LOSSES, CALENDAR YEARS 1979-1986 (In millions of dollars)

	New Issues	IRB Retirements	Cumulative Amount: Net Outstanding at Year End	Cumulative Amount: Average Amount Outstanding in Calendar Year	Fiscal Year Revenue Loss
1979	7,100	100	24,700	21,250	488
1980	8,400	200	32,900	28,850	715
1981	9,200	250	41,850	37,425	1,033
1982	10,100	250	51,700	46,825	1,388
1983	11,100	250	62,500	57,175	1,759
1984	12,200	500	74,250	68,450	2,139
1985	13,400	350	87,300	80,825	2,514
1986	14,700	500	101,500	94,450	2,875

SOURCE: Congressional Budget Office.

NOTE: Revenue loss estimates were determined by multiplying the average amount of outstanding new issues of tax-exempt bonds during each calendar year by the interest rate on alternative taxable loans in that same calendar year and the marginal tax bracket of investors in new issues of tax-exempt bonds. The aggregate losses in any year are the sum of losses for the current and previous years. These estimates may differ from those published in previous CBO reports. The revised figures are based on more recent estimates of future interest rates and IRB sales. For a breakdown of revenue loss calculations by year from 1975 to 1986, see Appendix E.

projected volume of small issues between 1980 and 1986 and its revenue consequences are shown in Table 2.

CBO's revenue loss estimates rest on the following assumptions:

- If IRBs were made taxable, interest rates on comparable new issues would range from 13.6 percent in 1981 to 8.7 percent in 1986;[4]

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4. These interest rates reflect CBO's projections for corporate bonds with Baa ratings. Some small issues have high ratings, while most substitute for commercial bank loans and are unrated. Since bank interest rates fluctuate widely, the rates on Baa bonds seemed to be the best single indicator of alternative taxable financing.